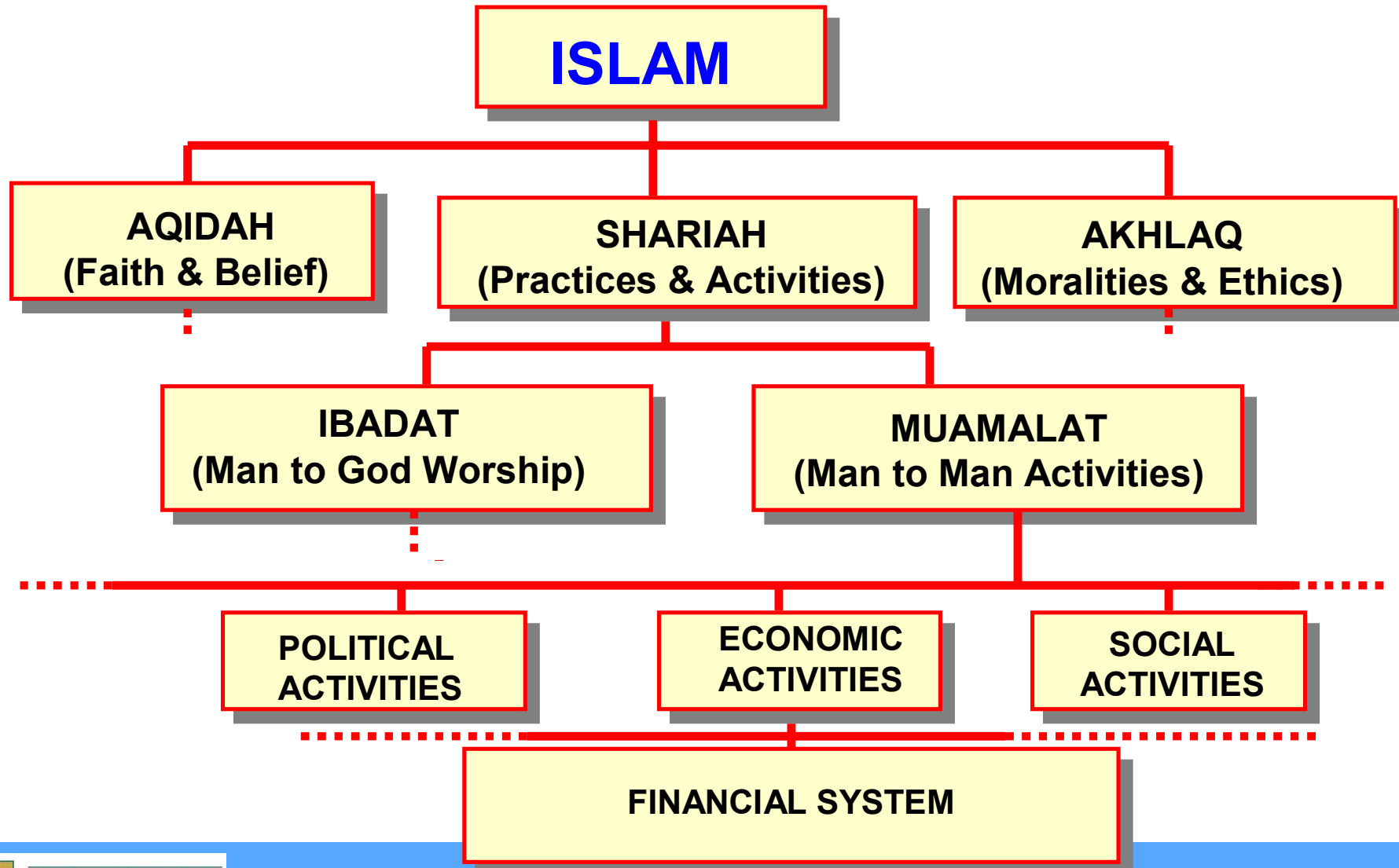
INTRODUCTION TO ISLAMIC FINANCIAL SYSTEM

presented by

RAZLI RAMLI
MANAGING CONSULTANT
SHARIAH BUSINESS ADVISORY

IS THERE
SUCH THING AS
FINANCE
IN ISLAM?

WHAT IS ISLAMIC FINANCE?

ISLAM, SHARIAH, MUAMALAT, BANKING AND FINANCE

WHAT IS ISLAMIC FINANCE?

Islamic finance is a term that reflects financial activities, which do not contradict to Islamic principles.

It is based on certain Shariah principles and contracts before they are translated into practical operations.

OBJECTIVES OF SHARIAH

1. Achieve socio-economic justice
2. Protection of public interest
3. Equitable distribution of income and wealth
4. Needs fulfillment
5. Growth & stability
6. Respectable source of income/earnings

PRIMARY SOURCE

- Al-Quran is a very word of Allah, which was transmitted to us through a reliable source.
- Close to 350 verses (ayat) in the Quran of which there are 70 verses on Muamalah.

PRIMARY SOURCE

- **Al-Sunnah – words / statements, action / deeds and approval (by confirming / denying) of the Prophet Muhammad (PBUH).**

- **All the above were later put in writing by his followers and transmitted to others as "hadith".**

PRIMARY SOURCE

- **Al-Sunnah – has three functions, i.e. to qualify, explain or elaborate the Holy Al Quran.**
- **Quranic support can be found in a number of verse and one of those is**

"Whoever obey the Messengers, verily obeys God" Al-Nisaa". (4:80)

SECONDARY SOURCES

Ijtma (consensus) - it is an unanimous decision which is accepted universally.

It is an endorsement by all the Muslim scholars on a particular issue at a particular time.

SECONDARY SOURCES

Qiyas (analogical reasoning) - Suggest on equality or close similarity. It is an extension of a precedent to a new case, because it shares the same effective cause or "ratio decidendi" ('illah). E.g. drug.

SECONDARY SOURCES

Maslahah (public interest) - it is a process of endorsing / arriving at a legal ruling based on an issue which is neither approved nor condemned by the Al Quran or As Sunnah, on the account of public interest consideration.

SECONDARY SOURCES

'Urf (customary practices) - it is a continuous practices of a society based on Maslahah. The practices are in line with Shariah. E.g. guarantee.

SECONDARY SOURCES

Istihab (presumption of continuity) - it is a presumption that a ruling on everything is permissible unless proven otherwise.

Itjtihah - Legal opinion / principles

GREAT IMAMS (SCHOLARS)

- **IMAM ABU HANIFAH (HANAFII)**

  His scholar compiled his teaching on muamalah in a book known as "The Mejelle" comprised of 1,851 Civil Law Codes

- **IMAM AHMAD B MUHAMMAD B HAMBAL (HAMBALI)**

- **IMAM MUHAMMAD IDRIS AL-SHAFII (SHAFII)**

- **IMAM MALIK B. ANAS (MALIKI)**

Differences between Conventional and Islamic Financial system

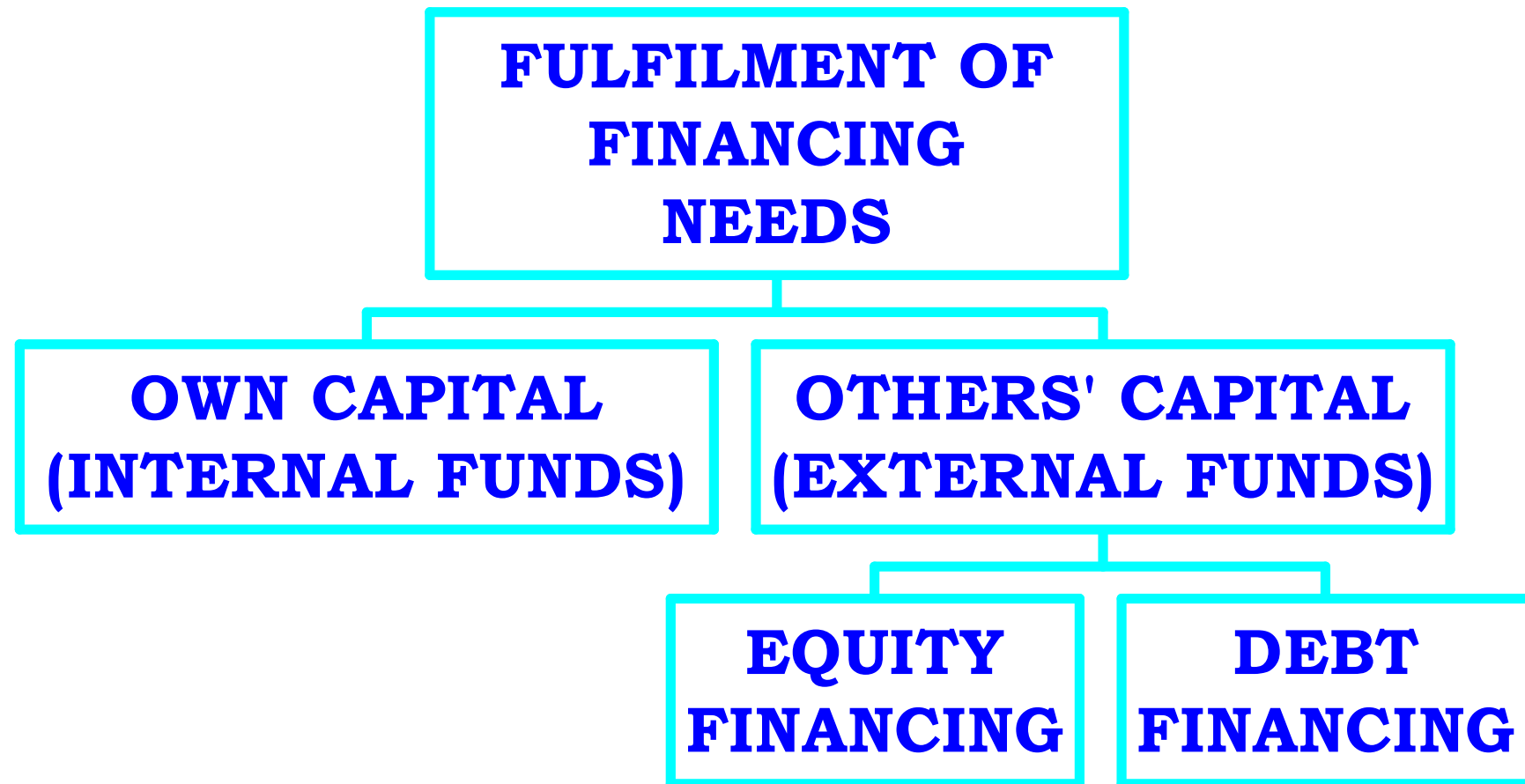
DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC FINANCIAL SYSTEM

Elements that differentiate between Conventional and Islamic financial system are ………………

- **Shariah point of view**

- **Operational & Practical aspects**

FINANCING REQUIREMENTS / NEEDS

- **FULFILMENT OF FINANCING NEEDS**
  - **OWN CAPITAL (INTERNAL FUNDS)**
  - **OTHERS' CAPITAL (EXTERNAL FUNDS)**
    - **EQUITY FINANCING**
    - **DEBT FINANCING**

EXTERNAL FINANCING DURING THE PRE-ISLAMIC ARAB SOCIETY

EXTERNAL FINANCING

EQUITY FINANCING

DEBT FINANCING

Contract of Profit Sharing

Contract of Exchange

Al Riba Nasiah Contract Involving Riba

Al Mudharabah Trustee Profit Sharing

BBA Deferred Installment Sale

Interest Based Lending

Al Musyarakah Joint Venture Profit Sharing

Al Murabahah Deferred Lump-sum Payment

Al Ijarah Leasing

Bai As Salam Salam Sale

Bai Al Istisna' Order Sale

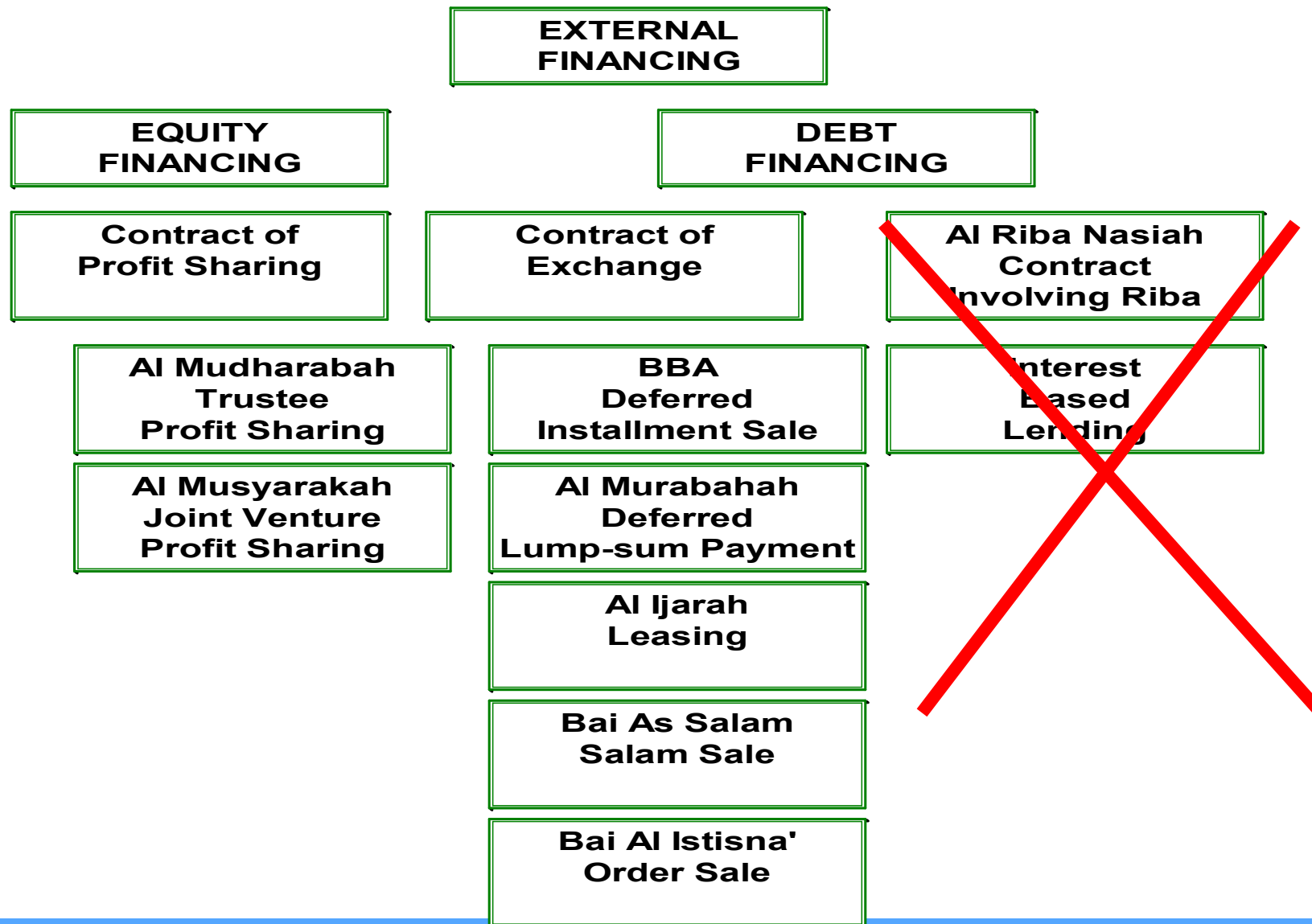
EXTERNAL FINANCING FROM ISLAMIC POINT OF VIEW

EXTERNAL FINANCING

EQUITY FINANCING

- Contract of Profit Sharing
  - Al Mudharabah Trustee Profit Sharing
  - Al Musyarakah Joint Venture Profit Sharing

DEBT FINANCING

- Contract of Exchange
  - BBA Deferred Installment Sale
  - Al Murabahah Deferred Lump-sum Payment
  - Al Ijarah Leasing
  - Bai As Salam Salam Sale
  - Bai Al Istisna' Order Sale
- ~~Al Riba Nasiah Contract Involving Riba~~
  - ~~Interest Based Lending~~

DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC FINANCIAL SYSTEM

Trade and commerce in Islam must conform to requirements of the Shariah, which broadly speaking refers to :

1. **Avoidance of prohibitions**

2. **Observing that every contract possesses all its essential elements and that every essential element meets its necessary conditions.**

SHARIAH CONTRACTS APPLIED IN ISLAMIC FINANCIAL SYSTEM

The contracts applied in Islamic finance may be categorize into three main contracts:

1. **TRADING CONTRACTS**

2. **PARTICIPATING CONTRACTS**

3. **SUPPORTING CONTRACTS**

ADDRESSING THE MISCONCEPTIONS

Misconceptions Against Islamic Finance

- Islamic finance is only for Muslims!
- Islamic finance is not profitable because no interest is charged!
- Islamic finance is only offered in Middle East!

ADDRESSING THE MISCONCEPTIONS

This reflects the challenge of the Islamic financial industry in clearing the misconceptions against it and creating better awareness among the consumers that Islamic finance is not only an alternative financial approach, but also in some aspects provides better value propositions to the consumers.

The
Islamic Financial System

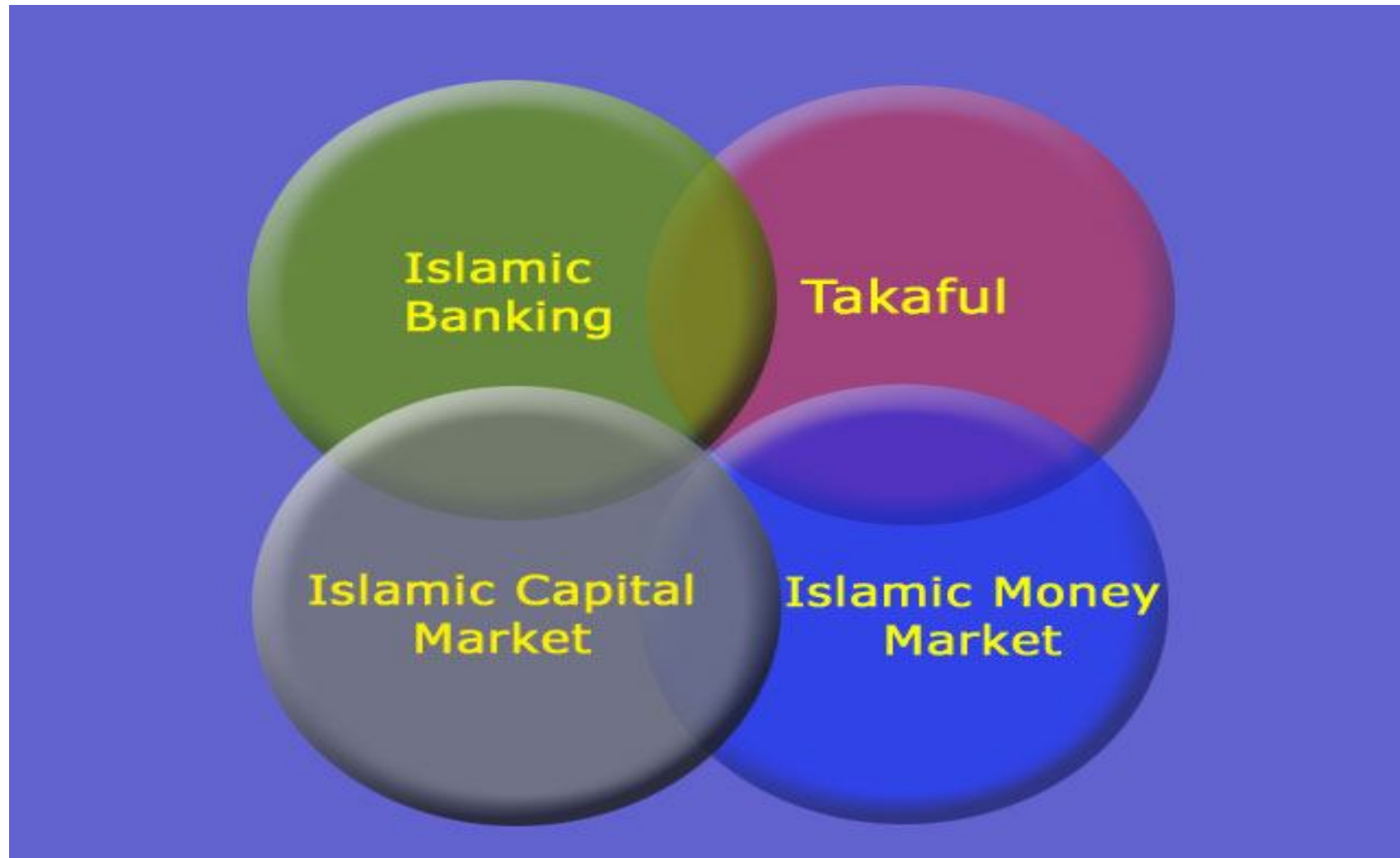
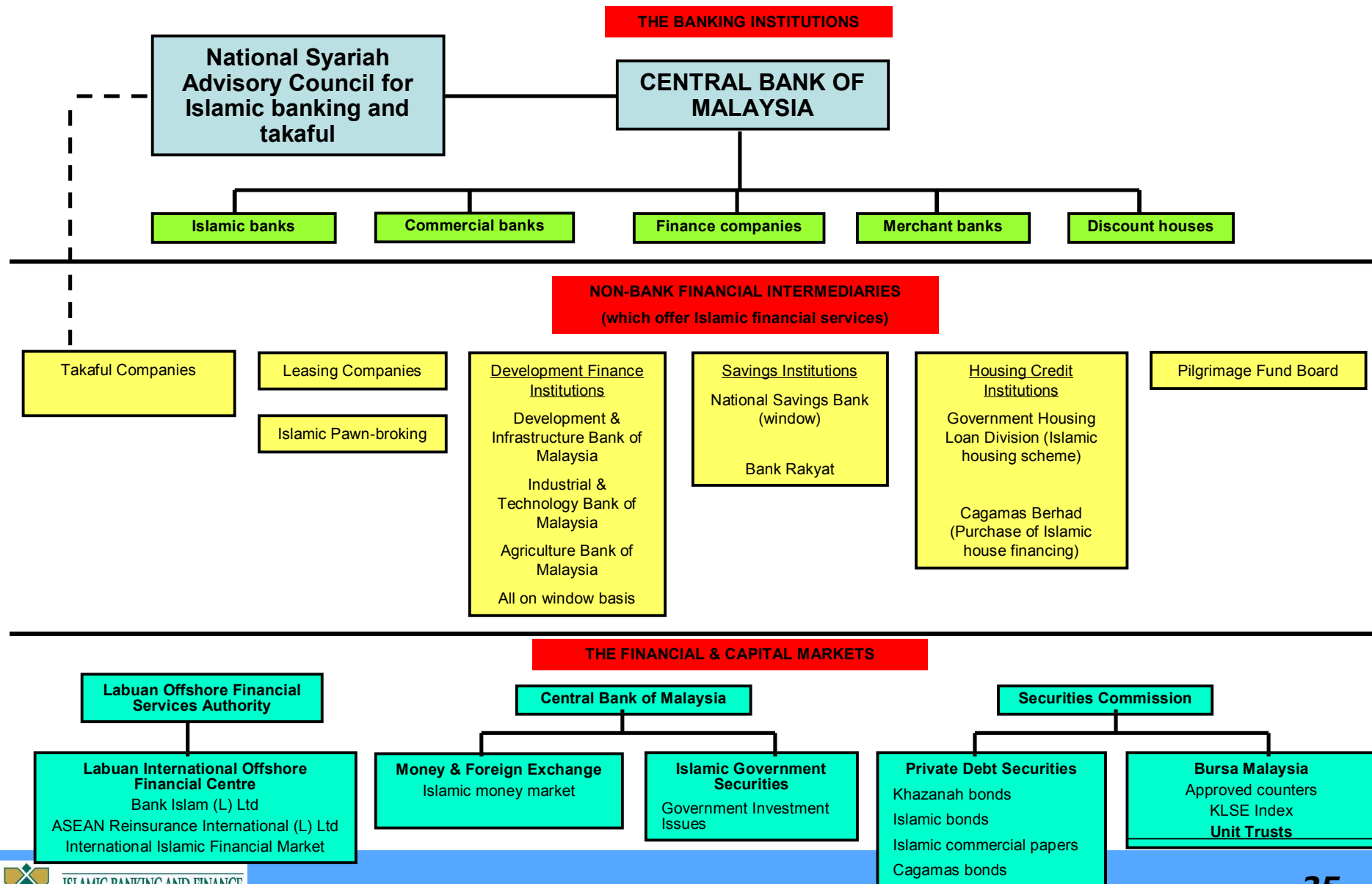
ISLAMIC FINANCIAL SYSTEM

A ***comprehensive*** Islamic Financial System

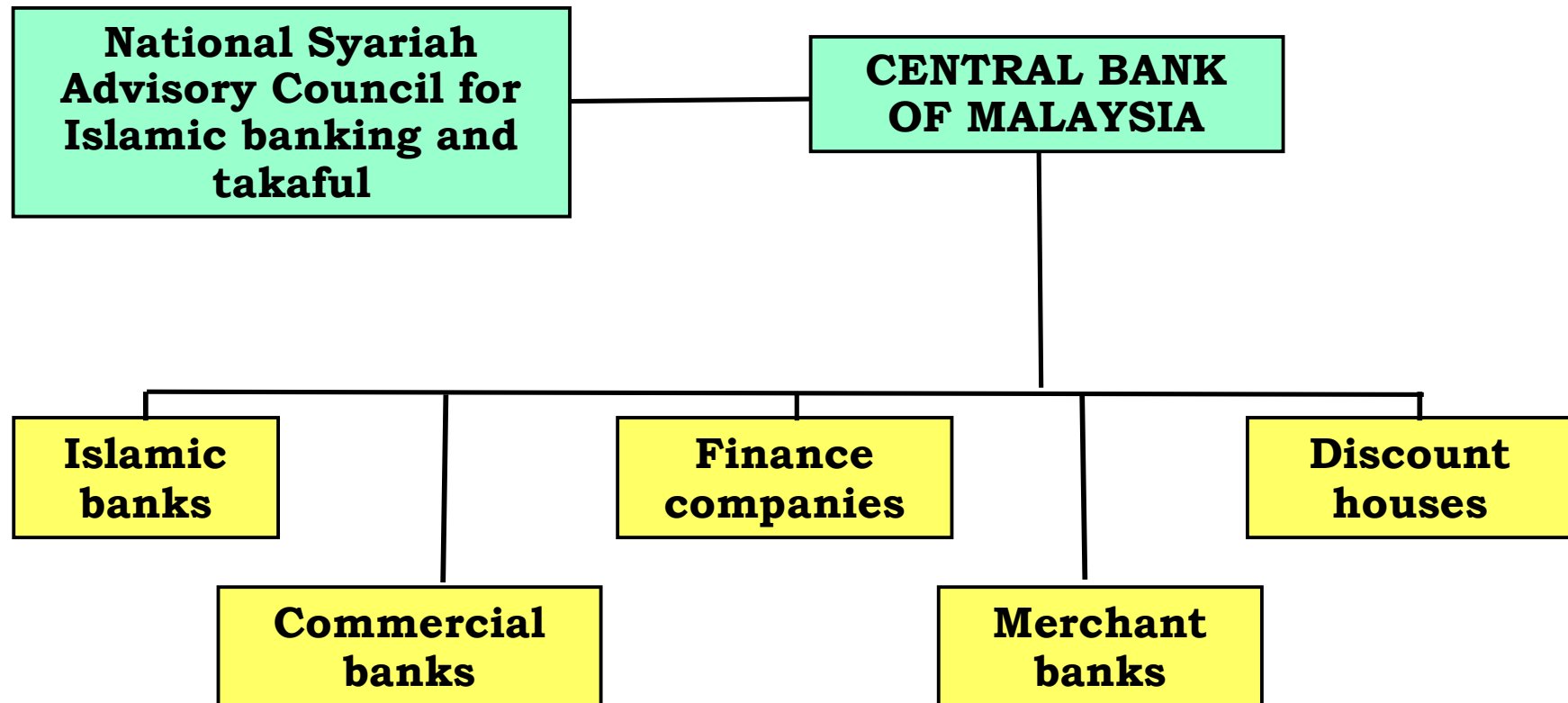
Islamic Banking

Takaful

Islamic Capital Market

Islamic Money Market

MALAYSIAN ISLAMIC FINANCIAL SYSTEM

THE BANKING INSTITUTIONS

- **National Syariah Advisory Council for Islamic banking and takaful**
- **CENTRAL BANK OF MALAYSIA**
  - **Islamic banks**
  - **Commercial banks**
  - **Finance companies**
  - **Merchant banks**
  - **Discount houses**

MALAYSIAN ISLAMIC FINANCIAL SYSTEM

NON-BANK FINANCIAL INTERMEDIARIES

Takaful Companies

Islamic Pawn-broking

Pilgrimage Fund Board

Leasing Companies

Savings Institutions

National Savings Bank

Bank Rakyat

Development Finance Institutions

Development & Infrastructure Bank of Malaysia

Industrial & Technology Bank of Malaysia

Agriculture Bank of Malaysia

Housing Credit Institutions

Govt.Housing Loan Division

Cagamas Berhad (Purchase of Islamic house financing)

MALAYSIAN ISLAMIC FINANCIAL SYSTEM

MONEY & CAPITAL MARKETS

Labuan Offshore Financial Services Authority

Labuan International Offshore Financial Centre

- Bank Islam (L) Ltd
- ASEAN Reinsurance International (L) Ltd
- International Islamic Financial Market

Central Bank of Malaysia

Money & Foreign Exchange

- Islamic money market

Islamic Government Securities

- Government Investment Issues

Securities Commission

Private Debt Securities

- Khazanah bonds
- Islamic bonds
- Islamic commercial papers
- Cagamas bonds

Bursa Malaysia

- Approved counters
- KLSE Index
- **Unit Trusts**

Development of Islamic Financial System in Malaysia

First Phase:
Setting up of Bank Islam Malaysia Berhad in 1983

Bank Islam was given a grace period of 10 year (1983-1993) to operate without competition in order to:

(i) protect its growth and development, and
(ii) to create as many products as possible.

Second Phase:
Increase Islamic Banks or Embark on Dual Banking

In 1993, Bank Negara Malaysia has allowed and even encouraged conventional banking institutions to offer Islamic banking products and services.

DEVELOPMENT OF ISLAMIC FINANCIAL SYSTEM IN MALAYSIA

Malaysia is one of several countries in the world that have implemented dual banking system.

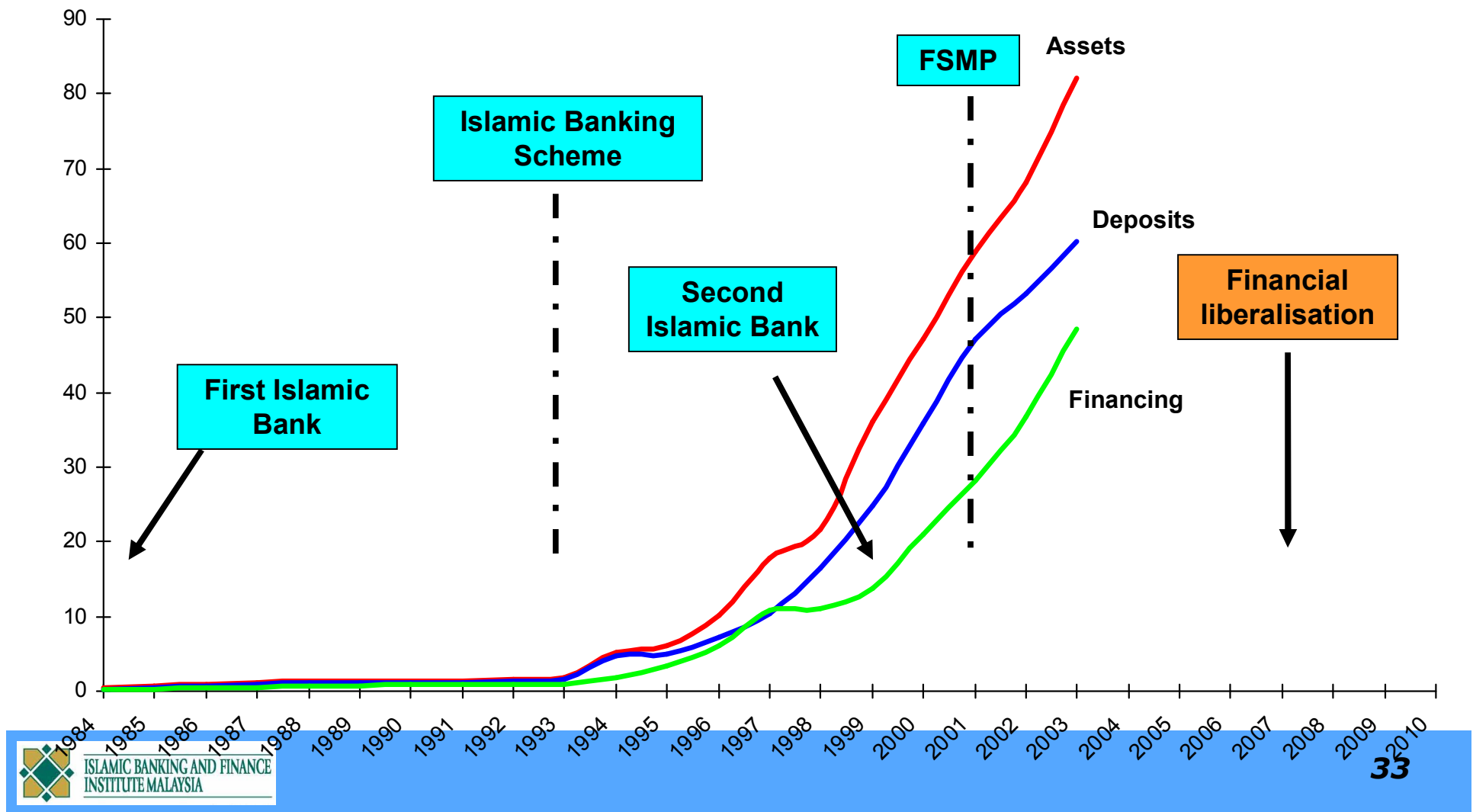
The advantages of dual banking:

i. **Instant increase in number of players**

ii. **Fastest way to disseminate Islamic banking on nationwide basis**

iii. **To optimize the existing banking infrastructure and resources and network.**

.... And now we moving towards

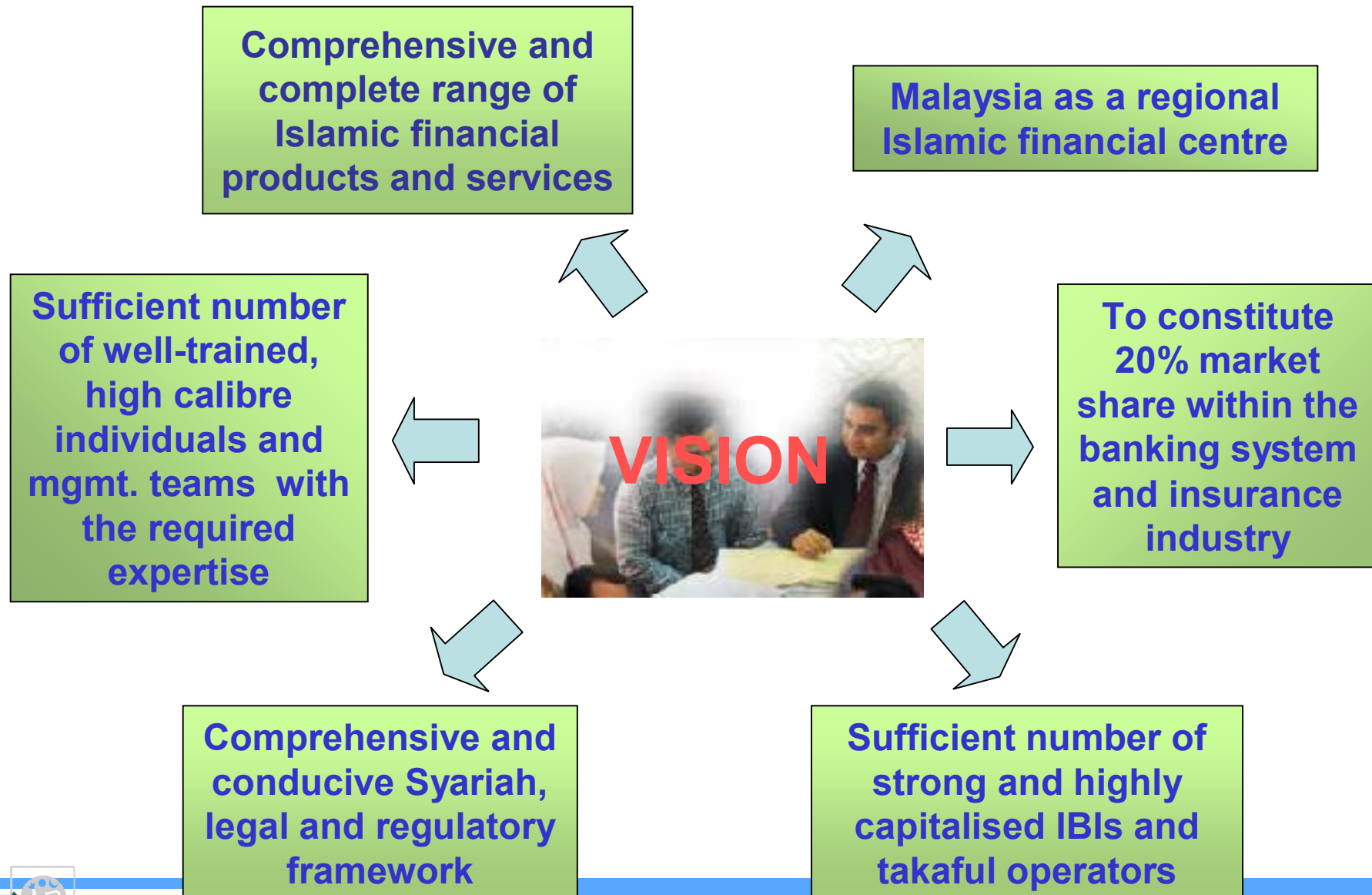
EVOLUTION OF ISLAMIC BANKING IN MALAYSIA

CHARTING OUR WAY FORWARD IN THE NEXT 10 YEARS

2001 - 2010

Financial Sector Master Plan (FSMP) was revealed on 1 March 2001, charts the 10-year course for Islamic banking and Takaful industry in Malaysia.

CHARTING OUR WAY FORWARD

"The overall objective is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation...."

CHARTING OUR WAY FORWARD

Comprehensive and complete range of Islamic financial products and services

Malaysia as a regional Islamic financial centre

Sufficient number of well-trained, high calibre individuals and mgmt. teams with the required expertise

To constitute 20% market share within the banking system and insurance industry

Comprehensive and conducive Syariah, legal and regulatory framework

Sufficient number of strong and highly capitalised IBIs and takaful operators

ROLES OF BNM IN THE DEVELOPMENT OF ISLAMIC FINANCIAL SYSTEM IN MALAYSIA

Regulatory framework development

- **Reviewing legal framework for IBs and SPIs**
  - **Strengthen IBA**
  - **Fine-tune BAFIA to accommodate unique IB features**
  - **Separate cap. adequacy, stat. reserve & liquidity ratio**
  - **Harmonise Shariah opinions on IB and finance**
- **Reviewing Takaful Act 1984 and HP Act 1967**
- **Consultative committee to look into standardising agreements/documents, and new financial products e.g. profit-sharing, floating rate products, swaps etc.**
- **Proposed for the establishment of a special Division in the judicial system to handle Islamic banking cases.**

ROLES OF BNM IN THE DEVELOPMENT OF ISLAMIC FINANCIAL SYSTEM IN MALAYSIA

Regulatory framework development

- Training for judges and lawyers to improve expertise on *muamalat* (Islamic finance)
- Pool of legal & Shariah experts to cater to rise in financial market & to enhance aspiration to be resource centre
  - Shariah experts to be active in banking and *takaful*
  - Competent in domestic and international banking
  - Documentation to be in accordance with Shariah
  - Perhaps Bar Council could hold exams for lawyers
- *Muzakarah* or discussions among Shariah experts, lawyers, bankers, *takaful* operators and regulators
- Harmonise opinions on *Bai Al-Dayn* (sale of debt) to make debt instruments more universally accepted

Firewall for Islamic Banking Scheme

- Several guidelines on Islamic Banking Scheme Operations
  - Requirement to establish an Islamic Banking Division
  - Requirement to observe a minimum Islamic Banking Fund
  - Requirement to observe similar prudential requirements – statutory reserve ratio, capital adequacy and liquidity
  - Requirement to have separate current/clearing accounts

Firewall for Islamic Banking Scheme

- Several guidelines on Islamic Banking Scheme Operations (con't)
  - Separate disclosure of IB operations in the Notes to Accounts of principal financial statements.
- Measure to adopt the capital adequacy framework for Islamic banking portfolio.
- Standard framework for the computation of the rate of return for Islamic banking institutions.

Shariah (Islamic law) Advisory Framework

- **Requirement to have Shariah Advisory Councils at Islamic Banks.**
- **Requirement to have Shariah consultants at IBS Banks.**
- **Establishment of National Shariah Advisory Council (NSAC) in 1997 under BNM to oversee uniformity in terms of Shariah opinions and instill discipline among banks and *takaful* operators.**
  - **NSAC is Shariah body of highest stature for Islamic banking and *takaful*.**
  - **Comprises academicians and Shariah experts on Islamic banking and finance.**

THE CRUCIAL FACTORS TO BE CONSIDERED IN THE IMPLEMENTATION OF ISLAMIC FINANCIAL SYSTEM

IMPLEMENTATION CHALLENGES

A very important point to note and remember

We are not implementing a new or additional product.

We are actually implementing a new or an alternative financial system.

...and therefore the implementation challenges are ....

THE KEY SUCCESS FACTORS

KEY SUCCESS FACTORS

- **The full support and backing from the Malaysian Government.**

- **The important role played by the Central Bank of Malaysia and Securities Commission.**

- **A proper and careful strategic planning and monitoring process.**

KEY SUCCESS FACTORS

- Creation of a comprehensive and conducive organizational structure.

- Supported by well-trained, high caliber individuals and management teams with the required expertise.

KEY SUCCESS FACTORS

- To optimize and tap the existing banking infrastructure and resources as well as the distribution network.

- Developed a comprehensive and complete range of Islamic Financial products and services.

CONCLUSION

- Islamic Banking has proven to be a viable venture.
- Its future depends very much on how issues and problems are being resolved.
- Creativity and innovation, without compromising Shariah requirements are the key factors.

End of Presentation

Wabillahi Al-taufek Wal-hidayah
Asslamu alaikum warahmatullahi wabarakatuh